

REPORT OF EXAMINATION  
OF THE  
BUSINESS ALLIANCE INSURANCE  
COMPANY  
AS OF  
DECEMBER 31, 2005

Filed June 29, 2007

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San Francisco, California  
May 9, 2007

Honorable Steve Poizner  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

**BUSINESS ALLIANCE INSURANCE COMPANY**

(hereinafter referred to as the Company) at its home office located at 900 Cherry Avenue, Suite 218, San Bruno, California 94066.

**SCOPE OF EXAMINATION**

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2005, including any material transactions and/or events occurring subsequent to the examination date, and noted during the course of the examination.

This examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

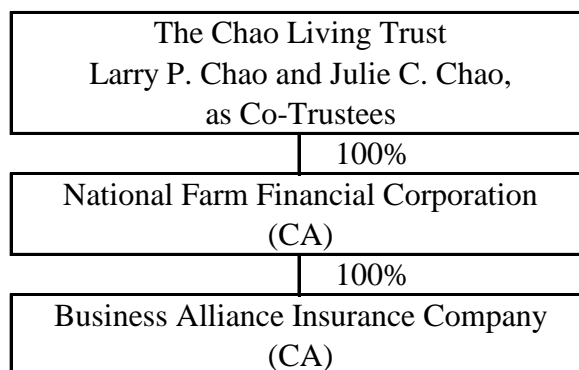
## COMPANY HISTORY

The Company was incorporated as a property and casualty insurer on November 12, 1996 under the laws of the State of California and commenced business on September 15, 1997.

In 2005, the Company's parent, National Farm Financial Corporation, contributed \$1.2 million in cash to the Company. The reason for the contribution was to enable the Company to obtain a higher A. M. Best rating.

## MANAGEMENT AND CONTROL

The Company is 100% owned by National Farm Financial Corporation (NFFC), an insurance holding company that is domiciled in California. NFFC is ultimately owned and controlled by Larry P. Chao and Julie C. Chao, as co-trustees of The Chao Living Trust. The following chart depicts the interrelationship among the companies within the holding company system as of December 31, 2005:



Management of the Company is currently vested in a two-member board of directors. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

## Directors

### Name and Residence

### Principal Business Affiliation

Larry P. Chao  
Hillsborough, California

Chairman, President, and Chief Executive  
Officer  
Business Alliance Insurance Company

Julie C. Chao  
Hillsborough, California

Secretary and Treasurer  
Business Alliance Insurance Company

## Principal Officers

### Name

### Title

Larry P. Chao  
Julie C. Chao

President  
Secretary and Treasurer

## Litigation Over the Proposed Sale of the Company

The Company's board of directors on May 21, 2005 approved a tender offer from PSM Holding Corp. (PSM) for the purchase of 100% of the Company's stock. PSM is a wholly-owned subsidiary of the Public Service Mutual Insurance Company (New York).

The Company indicated that the proposed acquisition was not consummated and that the parties to the acquisition are currently in litigation with each other over whether there was or was not a valid stock purchase agreement for the acquisition of the Company by PSM. The final outcome of the PSM lawsuit and the Company's countersuit could eventually result in the change in the ownership of the Company. Adverse outcomes against the Company, NFFC, and Mr. Larry Chao also could impact the Company financially if monetary damages are awarded. The Company, NFFC, and Mr. Larry Chao contend that they would prevail in court as it is their opinion that there was no valid stock purchase agreement for the sale of the Company.

The Company did not disclose the proposed sale of the Company to the California Department of Insurance (CDI). The potential sale was also not disclosed in the Company's 2005 holding company filing or in its 2005 annual CPA report. Only a vague disclosure regarding a lawsuit was made by the Company in its 2005 Annual Statement. The Company indicated that it did not disclose the sale in detail to the CDI or file a Form A with the CDI regarding the acquisition of the Company because the sale was never consummated.

#### Inter-Company Agreements

*SM@RT Software Licensing Agreement:* The Company has a licensing agreement with its parent company, National Farm Financial Corporation (NFFC) for the licensing of the SM@RT application software that was developed by NFFC. The licensing agreement calls for the Company to pay NFFC an annual licensing fee of 1% of gross written premium with a sliding scale when the premium volume exceeds \$20 million. California Insurance Code (CIC) Section 1215.5(b)(4) requires that any cost-sharing agreements with affiliates within the holding company system may only be entered into after the Company has notified the Commissioner in writing of its intention to enter into such a transaction and obtained prior approval. It is recommended that the Company comply with CIC Section 1215.5(b)(4) and obtain approval for its licensing agreement with NFFC.

*Facilities Sharing Arrangement:* The Company shares its principal office space with Larry P. Chao Insurance Services, Inc. (LPCIS). LPCIS pays a pro-rata share of the monthly rent based on the space utilized. This arrangement is considered a cost-sharing arrangement in accordance with CIC Section 1215.5(b)(4) and should be reduced to writing and approved by the CDI. It is recommended that the Company comply with CIC Section 1215.5(b)(4) with respect to its facilities sharing arrangement.

## TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company is licensed to write the business of insurance only in the State of California. The Company primarily writes commercial multiple peril and automobile mechanical breakdown insurance. Direct and net premiums written in 2005 were written in the following lines of business:

<b><u>Line of Business</u></b>	<b><u>Direct Written</u></b>	<b><u>% of Total</u></b>	<b><u>Net Written</u></b>	<b><u>% of Total</u></b>
Commercial multiple peril	\$17,202,458	85.6%	\$14,179,846	100%
Automobile mechanical breakdown	2,886,169	14.4%	0	0%
Totals	\$20,088,627	100.0%	\$14,179,846	100.0%

The commercial multiple peril policies are written through approximately 376 independent brokers. The Company's business owner policy is aimed primarily at small business owners within California.

Since 2004, the Company fronted a book of automobile mechanical breakdown business that was ceded 100% to National Service Contract Insurance Company RRG (NSCIC-RRG), an unauthorized reinsurer and a risk retention group that is domiciled in the District of Columbia. This arrangement is not in compliance with California Insurance Code (CIC) Section 130(k)(7)(B), which limits risk retention groups to assuming business from other risk retention groups or other qualified members. When informed of the above mentioned code section, the Company placed a moratorium on all new business, effective January 1, 2007. Because the mechanical breakdown policies that were issued from 2004 through 2006 were issued on a 3, 5, or 7-year term, it could take over 6 years to run-off the remainder of the book that is still in force. It is recommended that the Company develop and submit a plan of action to the California Department of Insurance with respect to how it plans to comply with California laws and run-off the remaining book of automobile mechanical breakdown business that is still on its books.

The automobile mechanical breakdown business is marketed via the internet by a program administrator, Interstate National Dealer Services, Inc. (INDS). INDS is an affiliate of NSCIC-RRG. Because INDS in 2004 and 2005 produced gross written premium that exceeded 5% of the Company's prior year's policyholder surplus and performed underwriting and claims adjustment duties, INDS is defined as a managing general agent in accordance to CIC Section 769.81 (MGA Act). The Company stated that it was unaware of the MGA Act and therefore did not comply with various requirements of the MGA Act, specifically CIC Section 769.84, which requires the Company to perform certain oversight duties with respect to INDS. It is recommended that the Company comply with the requirements of the MGA Act.

#### FIDELITY BOND AND OTHER INSURANCE

The Company has fidelity bond coverage of \$125,000, which is \$175,000 below the National Association of Insurance Commissioner's suggested minimum for the Company.

#### REINSURANCE

##### Assumed

The Company did not assume any reinsurance during the period of this examination.

##### Ceded

The following is a summary of the principal reinsurance agreements in force as of December 31, 2005:

Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Maximum Limits
Multiple Line Excess of Loss	Swiss Reinsurance America Corporation, New York Participation: 45%	<p><b>Property Business:</b> \$300,000 each risk per occurrence.</p> <p><b>Casualty Business:</b> \$300,000 per occurrence.</p> <p><b>Both (A) Casualty and (B) Property Loss in one occurrence:</b> Retained first \$300,000 combined property and casualty loss per occurrence, provided only one property could be combined in same occurrence.</p> <p>Such loss and retention thereon will be pro-rated.</p> <p>10% of loss in excess of policy limit, and 10% of extra contractual obligation.</p>	<p><b>Property Business:</b> \$700,000 each risk per occurrence. \$2,800,000 all risks per occurrence.</p> <p><b>Casualty Business:</b> \$700,000 per occurrence. Company warranted policy limit per occurrence not to exceed \$1,000,000.</p> <p><b>Both (A) Casualty and (B) Property Loss in one occurrence:</b> Reimbursed the company for the difference between the company's first \$300,000 retention and the pro-rated retention on each casualty and property loss.</p>
Commercial Property and Casualty per risk Excess of Loss	American Re-insurance Company Participation: 55%	<p><b>Property Business:</b> \$300,000 each risk per occurrence.</p> <p><b>Casualty Business:</b> \$300,000 per occurrence</p> <p><b>Both (A) Casualty and (B) Property Loss in one occurrence:</b> \$300,000 combined property and casualty loss per occurrence.</p> <p>10% loss in excess of policy limit and extra contractual obligations.</p>	<p><b>Property Business:</b> \$700,000 each risk per occurrence. \$2,100,000 all risks per occurrence.</p> <p><b>Casualty Business:</b> \$700,000 per occurrence.</p> <p><b>Both (A) Casualty and (B) Property Loss in one occurrence:</b> \$300,000 per occurrence additional reinsurance provided, if combined (A) and (B) retention exceeds \$300,000.</p>
Type of		Company's	

<b>Contract</b>	<b>Reinsurer's Name</b>	<b>Retention</b>	<b>Reinsurer's Maximum Limits</b>
Property Catastrophe Excess of Loss	American Re-insurance Company (100%)	\$1,000,000 each occurrence, plus first 5% of ultimate net loss.	95% of ultimate net loss in excess of \$1,000,000 each occurrence, but limited to: \$2,850,00 each occurrence, and \$5,700,000 all occurrences.  Reinstatement: The face amount of the Agreement as reduced by each claim may be reinstated, but reinsurer's liability would never exceed: \$2,850,000 each occurrence, and \$5,700,000 all occurrences.
100% Quota Share – Auto Mechanical Breakdown	National Service Contract Insurance Company RRG *	Zero retention (100% ceded).	No limit (100% ceded).
100% Quota Share – Plate Glass	US Plate Glass Insurance Company	Zero retention (100% ceded).	No limit (100% ceded).

\* Unauthorized.

The Company's reinsurance agreements with American Re-insurance Company and Swiss Reinsurance America Corporation are deficient in that they contain special termination provisions that allow the reinsurer to terminate the agreement in the event of certain actions on the part of regulatory authorities (e.g., conservation, receivership, cease writing order) or insolvency. The provisions do not adhere to Statements of Statutory Accounting Principle No. 62, paragraph 7. It is recommended that the Company and its reinsurers work with the California Department of Insurance Legal Division to clear the deficiencies with respect to the special termination provisions in the agreements.

### ACCOUNTS AND RECORDS

During the course of the examination, the examiners noted numerous reporting errors in the Company's Annual Statement and instances of non-compliance with the National Association of Insurance Commissioner's (NAIC) Annual Statement Instructions - Property and Casualty (Annual Statement Instructions) and the NAIC's Statements of Statutory Accounting Principles (SSAP)

despite recommendations in the prior two examination reports regarding many of these areas.

Examples of errors and areas of non-compliance include:

The Company did not adhere to SSAP 65, paragraph 7 and SSAP 53, paragraph 7 in calculating its earned and unearned premiums with respect to its fronted book of mechanical break-down business. The policies were written on a 3, 5 or 7-year term with 90% written at the 5-year term. Instead of using the actual contract terms, the Company calculated its earned and unearned premiums based on the assumption that all mechanical breakdown policies were written on a 5-year term.

The Company's application program that calculates the 90-days overdue premiums on uncollected and deferred premiums appears to be calculating the overdue premiums incorrectly (resulting in a slightly higher overdue for the samples that were reviewed).

The prior year's column on page 2 of the Company's 2005 Annual Statement was off by \$3,496,028 and did not agree with the total from the 2004 Annual Statement.

The prior year's column on page 4 of the Company's 2004 Annual Statement for surplus as regard policyholders (\$6,720,724) differed from what was reported in its 2003 Annual Statement (\$6,710,475).

The Company included other expenses as part of the total that was reported as taxes, licenses and fees.

The Company grouped balances from two different bank accounts together and reported it as one account in Schedule DA, Part 1.

The Company did not properly disclose unsecured reinsurance recoverable that exceeded 3% of its policyholders' surplus in the Notes to the Financial Statements in accordance to SSAP 62, paragraph 65.

The Company combined uncollected premium (Annual Statement page 2, line 13.1) with deferred premiums (Annual Statement page 2, line 13.2) and reported both under line 13.2, which is not in accordance with Annual Statement Instructions.

The Company combined advance and unearned premiums and reported both as unearned premiums, which is not in accordance with Annual Statement Instructions.

The Company did not properly report its net unrealized capital gains by not running the gain through the Gains and (Losses) in Surplus section of the Statement of Income, page 4, line 24.

The Company did not complete the schedules relating to deferred tax assets and deferred tax liabilities in the Notes to Financial Statements section of the Annual Statement, which should have been completed since SSAP 10 became effective in 2001.

The Company failed to disclose in the Notes to Financial Statements its unsecured reinsurance recoverables in accordance with SSAP 62, paragraph 65 with respect to recoverables from National Service Contract Insurance Company RRG (NSCIC-RRG) and American Re-Insurance Company.

The Company incorrectly included NSCIC-RRG (an unauthorized reinsurer) in Schedule F, Part 3, within the group of authorized reinsurers.

The Company was not able to provide documentation to support the allocation method for paid adjusting and other expenses that support the entry to Schedule P, Part 1E, column 8.

The Company did not comply with the prior examination recommendation that it classify adjusting and other expenses in accordance with Annual Statement Instructions, as opposed to allocating a portion of the total expenses.

Many of the errors occurred because of a lack of control procedures to detect and prevent the types of errors noted. Additionally, the Company does not appear to have sufficient levels of appropriately qualified and trained personnel in the financial reporting processes. It is recommended that the Company exercise due diligence to insure that its annual statements are completed in accordance with SSAPs and Annual Statement Instructions. It is recommended that the Company establish control procedures to detect and prevent the types of reporting errors that were noted during the examination from occurring in the future. It is also recommended that the Company employ sufficient levels of appropriately qualified and trained personnel in the financial reporting processes.

The Company does not have policies and claims data on-hand with respect to the book of automobile mechanical breakdown policies that it fronted on behalf of the NSCIC-RRG. Since the policies are written on the Company's policy form, it is recommended that it have on-hand detailed policies and claims data with respect to its policyholders and claimants for its book of automobile mechanical breakdown business. It is also recommended that the Company document backup procedures in the event that its program administrator, Interstate National Dealer Services, Inc. is unable or unwilling to process the Company's claims as it relates to its book of automobile mechanical breakdown business.

### Information System Controls

A limited review was conducted of the Company's general controls over its electronic information system. Based on the review, deficiencies were noted in the areas of management controls, logical access controls, data security, and disaster recovery and contingency planning. The control deficiencies that were noted were provided to the Company. It is recommended that the Company review the comments and recommendations and institute procedures to strengthen its internal control over its information systems.

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders from December 31, 2001  
through December 31, 2005

Reconciliation of Examination Changes as of December 31, 2005

Statement of Financial Condition  
as of December 31, 2005

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$18,049,328	\$	\$18,049,328	
Common stock	979,358		979,358	
Cash and short-term investments	6,658,012		6,658,012	
Aggregate write-ins for invested assets	2,910,687		2,910,687	
Investment income due and accrued	185,950		185,950	
Deferred premiums, agents' balances and installment booked but deferred and not yet due	3,281,393	56,964	3,224,429	
Amount recoverable from reinsurers	396,777		396,777	
Other amounts receivable under reinsurance contracts	55,892		55,892	
Current federal income tax recoverable and interest thereon	103,321		103,321	
Aggregate write-ins for other than invested assets	<u>1,000</u>		<u>1,000</u>	
Total assets	<u>\$32,621,718</u>	<u>\$ 56,964</u>	<u>\$32,564,754</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 6,185,346	(1)
Loss adjustment expenses			1,681,689	(1)
Commissions payable			27,933	
Other expenses			162,782	
Taxes, licenses and fees			59,282	
Unearned premiums			6,984,892	
Ceded reinsurance balances payable			1,510,770	
Provision for reinsurance			840,000	(2)
Funds held under reinsurance treaties			2,910,687	
Provision for premium restitution			<u>629,605</u>	(3)
Total liabilities			20,992,986	
Common capital stock		\$2,600,000		
Gross paid-in and contributed surplus		5,490,240		
Unassigned funds (surplus)		<u>3,481,528</u>		
Surplus as regards policyholders			<u>11,571,768</u>	
Total liabilities, surplus and other funds			<u>\$32,564,754</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

Earned premiums		\$14,246,209
Deductions:		
Losses incurred	\$5,117,640	
Loss expenses incurred	1,625,310	
Other underwriting expenses incurred	5,747,166	
Aggregate write-ins for underwriting deductions	<u>(712,926)</u>	
Total underwriting deductions		<u>11,777,190</u>
Net operating gain		2,469,019

Investment Income

Net investment income earned	\$ 737,776	
Net realized capital losses	<u>(31,188)</u>	
Net investment gain		706,588

Other Income

Finance and services charges not included in premiums	\$ 362,258	
Aggregate write-ins for miscellaneous income	<u>835,700</u>	
Total other income		<u>1,197,958</u>
Net income before federal income tax		4,373,565
Federal income taxes incurred		<u>1,580,000</u>
Net income		<u>\$ 2,793,565</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		\$ 9,093,209
Net income	\$2,793,565	
Change in nonadmitted assets	(45,347)	
Change in provision for reinsurance	(840,000)	
Provision for premium restitution	(629,605)	
Surplus paid in	1,200,000	
Aggregate write-ins for gain and losses in surplus	<u>(54)</u>	
Change in surplus as regards policyholders		<u>2,478,559</u>
Surplus as regards policyholders, December 31, 2005		<u>\$11,571,768</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2001 through December 31, 2005

Surplus as regards policyholders, December 31, 2001, per Examination			\$ 5,094,595
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$6,789,656	\$	
Change in nonadmitted assets		42,844	
Provision for reinsurance		840,000	
Surplus paid in	1,200,000		
Provision for premium restitution		629,605	
Aggregate write-in for gains and losses in surplus	<u>                    </u>	<u>54</u>	
Total gains and losses	<u>\$7,989,656</u>	<u>\$1,512,483</u>	
Increase in surplus as regards policyholders			<u>6,477,173</u>
Surplus as regards policyholders, December 31, 2005 per Examination			<u>\$11,571,768</u>

Reconciliation of Examination Changes  
as of December 31, 2005

<u>Liabilities</u>	<u>Per Company</u>	<u>Per Examination</u>	<u>Surplus Increase (Decrease)</u>	<u>Note</u>
Provision for reinsurance	\$ 0	\$ 840,000	\$ (840,000)	(2)
Provision for premium restitution	0	629,605	<u>(629,605)</u>	(3)
Net decrease to surplus			(1,469,605)	
Surplus as regards policyholders, December 31, 2005, per Company			<u>13,041,373</u>	
Surplus as regards policyholders, December 31, 2005, per Examination			<u>\$11,571,768</u>	

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Losses and Loss Adjustment Expenses

Based upon a review conducted by a Casualty Actuary from the California Department of Insurance (CDI), the Company's reserves for losses and loss adjustment expenses were found to be reasonably reported and have been accepted for the purposes of this examination.

In validating the integrity of the Company's loss data, however, the examiners noted numerous errors in the samples of loss transactions that were selected for review. Many of the errors were the result of lack of procedural controls and supervision over the reporting of loss reserve changes by the Company's Claims Department to the Accounting Department and the recording of loss reserve changes by the Accounting Department into an Excel spreadsheet that the Company maintains manually. The Excel spreadsheet forms the basis for the actuarial loss triangles used by the Company's consulting actuaries to project the Company's loss reserves. Other errors were the result of the lack of controls and reconciliation procedures to insure that the claims data and transactions are accurately reflected in the Company's claim file, Instar claim system, and its loss data/triangles (Excel spreadsheet). The errors noted were numerous and material enough for the examiners to conclude that the Company's loss data/triangles could not be relied upon as the basis to project the Company's ultimate losses using the incurred method. Because the incurred loss data was unreliable, the CDI actuary had to adjust his actuarial methodology to include 2006 paid losses and employ other actuarial methodologies and tests before he could issue his opinion on the adequacy of the Company's 2005 loss reserves.

It is recommended that the Company institute control procedures and perform monthly reconciliations to insure that the Company's loss data is accurately reflected across all systems that maintain loss data and loss transactions.

## (2) Provision for Reinsurance

The Company did not establish a provision for reinsurance with respect to the uncollateralized portion of the ceded balances relating to the fronted book of automobile mechanical breakdown business that ceded 100% to National Service Contract Insurance Company RRG (NSCIC-RRG), an unauthorized reinsurer. As a result, the Company's provision for reinsurance was increased by \$840,000.

## (3) Provision for Premium Restitution

As the result of an underwriting and rating examination conducted by the California Department of Insurance's Field Rating and Underwriting Bureau (FRUB), FRUB concluded that policyholders were overcharged on some of the policies that were issued by the Company over several years. The primary cause of the premium overcharges was the Company's computerized rating program which was not properly programmed to apply certain discount and other rating factors to arrive at the policy premiums that correspond with its filed rates. FRUB estimated that the overcharges amounted to about \$529,605. FRUB is requesting that the Company make restitution to its policyholders for the overcharges as policies are renewed. As a result, the examiners have established a 'Provision for premium restitution' on the Company's balance sheet in the amount of \$629,605. The \$629,605 includes FRUB's estimate of the premium overcharges plus estimated costs of \$100,000 that the Company will need to expend to perform the research to identify which policyholders were overcharged.

# SUMMARY OF COMMENTS AND RECOMMENDATIONS

## Current Report of Examination

*Management and Control – Inter-Company Agreements (Page 4):* It is recommended that the Company comply with California Insurance Code (CIC) Section 1215.5(b)(4) and obtain approval for its licensing agreement with its parent company. It is recommended that the Company comply with CIC Section 1215.5(b)(4) with respect to its facilities sharing arrangement.

*Territory and Plan of Operations (Page 5):* It is recommended that the Company develop and submit a plan of action to the California Department of Insurance (CDI) with respect to how its plans to comply with California laws and run-off the remaining book of automobile mechanical breakdown business that is still on its books. It is recommended that the Company comply with the requirements of the MGA Act with respect to Interstate National Dealer Services, Inc., the program administrator of its automobile mechanical breakdown business.

*Reinsurance (Page 6):* It is recommended that the Company and its reinsurers work with the CDI Legal Division to clear the deficiencies with respect to the special termination provisions in the agreements.

*Accounts and Records (Page 8):*

- It is recommended that the Company exercise due diligence to insure that its annual statements are completed in accordance with Statements of Statutory Accounting Principles and NAIC's Annual Statement Instructions – Property and Casualty.
- It is recommended that the Company establish control procedures to detect and prevent the types of reporting errors that were noted during the examination from occurring in the future.
- It is recommended that the Company employ sufficient levels of appropriately qualified and trained personnel in the financial reporting processes.
- It is recommended that the Company have on-hand detailed policies and claims data with respect to its policyholders and claimants for its book of auto mechanical breakdown business.
- It is recommended that the Company document backup procedures in the event that its program administrator, Interstate National Dealer Services, Inc. is unable or unwilling to process the Company's claims as it relates to its book of auto-mechanical breakdown business.

*Accounts and Records – Information System Controls (Page 11):* It is recommended that the Company review the comments and recommendations and institute procedures to strengthen its internal control over its information system.

*Comments of Financial Statement Items – Losses and Loss Adjustment Expenses (Page 16):* It is recommended that the Company institute control procedures and perform monthly reconciliations to insure that the Company's loss data is accurately reflected across all systems that maintain loss data and loss transactions.

#### Previous Report of Examination

*Management and Control - Management Agreements (Page 4):* It was recommended that the Company file its written agreements with the California Department of Insurance (CDI) in accordance with California Insurance Code (CIC) Section 1215.5(b)(4). The Company indicated that the agreement with Julie Chao to suspend her salary until the Company became profitable was not filed because it was cancelled. The Company's agreement noted in the Company's December 31, 2001 board minutes to suspend Larry P. Chao's salary until the Company begins to show profits was also not filed as the Company indicated that Larry P. Chao is currently drawing salary as an employee of the Company. The agreement that its parent company lease various computer and equipment to the Company was never implemented and has been terminated and was also not filed.

*Corporate Records (Page 4):* It was recommended the Company comply with the CIC Sections 1200 and 1201. The Company is currently in compliance.

*Reinsurance – Ceded (Page 5):* It was recommended that the Company amend its quota share agreement with US Plate Glass Insurance Company to include a proper insolvency clause in accordance with CIC Section 922.2. The Company amended its quota share agreement to include a proper insolvency clause.

*Accounts and Records – Information System Controls (Page 6):* It was recommended that the Company evaluate the recommendations from the information system review and make appropriate changes to strengthen its information system controls. The Company adopted some of the recommendations that were made. However, new recommendations regarding the Company's information systems are included under the Accounts and Records section of this report.

*Accounts and Records – Risk Based Capital (Page 6):* It was recommended that the Company re-run its 2001 Risk Based Capital (RBC) Report to determine the appropriate authorized control level. The Company did not re-run its RBC report as recommended but it did have its consulting CPA review the RBC report. The conclusion from the review was that the authorized control level as reported in its 2001 Annual Statement was appropriate.

*Accounts and Records – Claims Reports (Page 7):* It was recommended that the Company reconcile its Excel spreadsheet with its Instar System and claim files. It was also recommended the Company take the steps necessary to produce detailed claim reports and to maintain documentation to support adjustments to Schedule P data. The Company indicated that it has made improvements in this area. However, the examiners' data validation work on loss data indicated that similar problems still exist in this area, which is the subject of a report comment under the Comment on Financial Statement Item – Loss and Loss Adjustment Expenses section.

*Accounts and Records - Premiums and Unearned Premium (Page 8):* It was recommended that the Company enhance its systems to be able to produce detailed written premium reports. The current situation has not improved. The Company indicated that its Instar application system has severe limitations and does not allow it to adopt the recommendation. However, the Company has indicated that it is in the process of developing an in-house computer application that would address the problems noted.

*Comments on Financial Statement Items - Bonds (Page 13):* It was recommended that the Company file its unregistered securities with the Securities Valuation Office or maintain documentation to support a provisionally exempt status. The Company was unable to provide any documentation that demonstrated that it adopted the prior examination recommendation. However, the issue is moot because the Company currently does not own the securities that were the subject of this recommendation.

*Comments on Financial Statement Items - Aggregate Write-In for Other Than Invested Assets (Page 13):* It was recommended that the Company consistently report purchased interest as

interest, dividends, and real estate income due and accrued. The Company has complied with this recommendation.

*Comments on Financial Statement Items - Loss Adjustment Expenses (Page 13):* It was recommended that the Company classify Adjusting and Other (AO) expenses in accordance with the NAIC's Annual Statement Instructions as opposed to just allocating a portion of the total expenses. The Company was not able to demonstrate that it was classifying AO expenses in accordance with NAIC Annual Statement Instructions as the examiners noted in several claim files reviewed that all claim expenses were classified as Defense and Cost Containment expenses. This issue is again a subject of a comment and recommendation in the Accounts and Records section of this report.

## ACKNOWLEDGMENT

The cooperation, courtesy and assistance extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/s/

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